Securities Industry Trends

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AN ANALYSIS OF EMERGING TRENDS IN THE SECURITIES INDUSTRY
Produced by the SIA Research Department

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OBSERVATIONS ON THE RETAIL BUSINESS

Substantial change has occurred within the securities industry since last October. This issue of Trends focuses on and quantifies key shifts on the retail side of the business.[1]

To provide a perspective on the retail business today, let's look at two fundamental questions.

- o What do the numbers show?
- o What are some of the key challenges facing those responsible for the retail side of the industry?

What's Happened Since the End of 1985?

Let's begin by taking a look at the numbers via setting up a hypothetical situation.

Having had an outstanding year in 1985, you decided back then to realize a lifetime ambition. You worked out a sabbatical and took off for a remote island to write the definitive novel of Wall Street -- which you planned to title "Bon Vanities." And now, after being completely incommunicado through all of 1986, 1987 and year to date 1988, you've returned. Alas, your novel has been viciously rejected by 612 publishers. So, you've ended your writing career and decided to resume your vocation as a retail sales and marketing executive. Welcome back.

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1 Based on a presentation by Adrian L. Banky at SIA's September, 1988 Sales and Marketing Conference. SIA welcomes contributions to Trends from all sources, from member firms as well as others, relating to the securities industry and capital markets. Please send submissions to the attention of Jeff Schaefer or George Monahan, SIA Research Department.

After being out of touch for the past two years and nine months, you're naturally very curious about how things have gone in the markets and the business. Naturally, you ask for some numbers on what's happened during your absence.

"What about the DJIA?" Well, prior to your departure the Dow had been moving splendidly, going from about 900 at the end of 1981 to an all-time year-end record of 1547 when you sailed at the end of 1985. But today, it's up to about 2100! Outstanding news on the Dow...from 1547 to 2100. Great!

How about volume? You receive some more stunning good news: average daily volume on the NYSE charged strongly ahead -- from a then-record 109 million shares in 1985 to 170 million shares 1988 year to date! A 56% increase in less than three years. Looking good!

Next, you ask about revenues from mutual fund sales which exploded 16 times over from 1980 to 1985 -- reaching $1.6 billion for 1985. With that sort of phenomenal growth you were obviously concerned the pendulum might have swung the other way during your absence. Well, more great news: we're on track to do another phenomenal $1.6 billion in fund sales this year! Terrific! Isn't this a great business?

Now with the Dow and NYSE volume up and fund sales holding strong, you hope that commission revenues may also have done well. Right again. Commissions rose from $8.2 billion in 1985 to a pace that may exceed $9 billion for 1988!

And so, the picture is looking very, very good. But" aha," you say. Maybe only retail blossomed during your absence; the rest of the business may have turned soft. Your fears are totally dissolved given total revenues in the securities industry. In 1985, you left a $39 billion industry; a record high. Now, you are back and the trend suggests we could have a $51 billion business in 1988! Revenues are up 31%! Wow -what a business!

You're feeling just great. Dow and volume up. Mutual fund sales still very strong. Commissions and industry revenues also up. Terrific! Your only regret is missing all the fun.

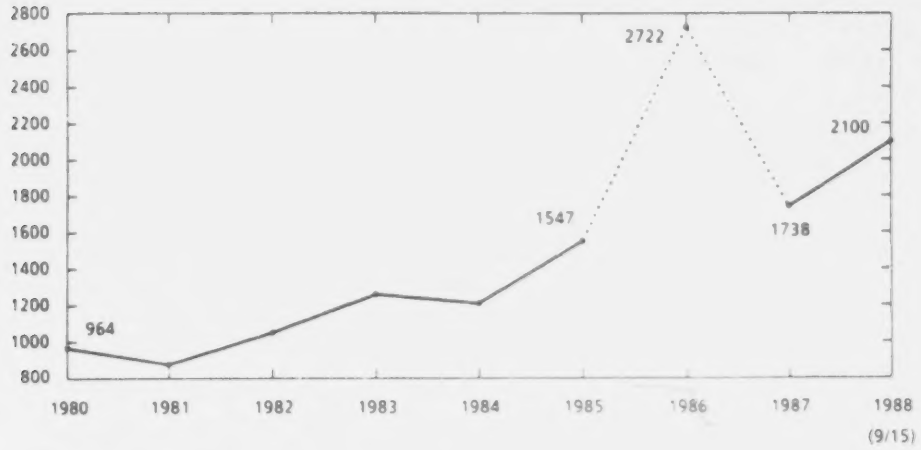
Time to Look Behind the Numbers

But, after you basked a bit in the glow of all these warm numbers, you begin to get a little curious about some of the details of the past two years and nine months. For example, you ask, "Did the Dow march steadily up to the 2100 area -- or was there some volatility?"

Well, yes, there was some volatility. In fact, about 1,000 points worth of volatility during just a matter of weeks in 1987. **Exhibit 1** reveals that while we are indeed up 550 points from the time you left at the end of 1985, we're also down over 600 points from the high reached in August, 1987. You missed a true roller coaster ride.

Exhibit 1

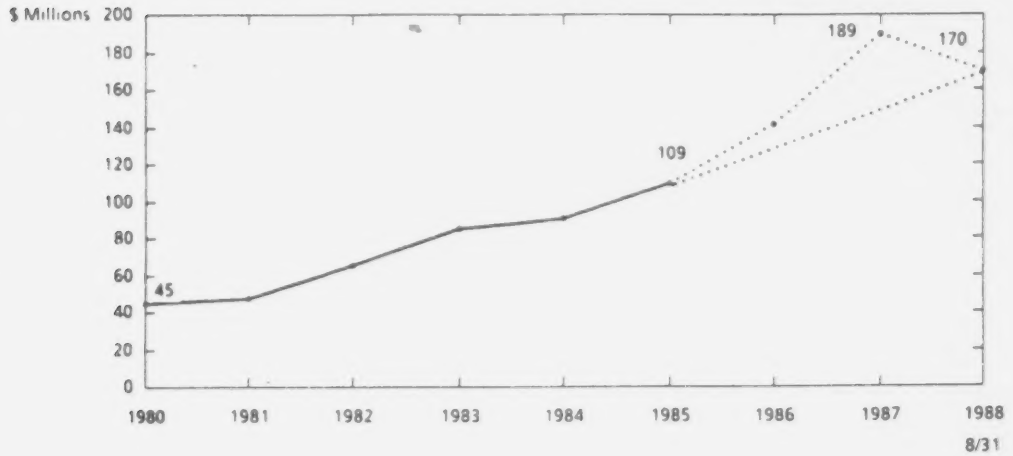
DJ Industrials



And how about the pattern in NYSE volume? **Exhibit 2** shows that NYSE daily share volume, while well up from 1985 levels, has turned south from last year's 189 million share daily average. Hence, strongly up from 1985, but down 11% from last year (not even adjusted for increased role of specific trading strategies such as dividend capture programs).

Exhibit 2

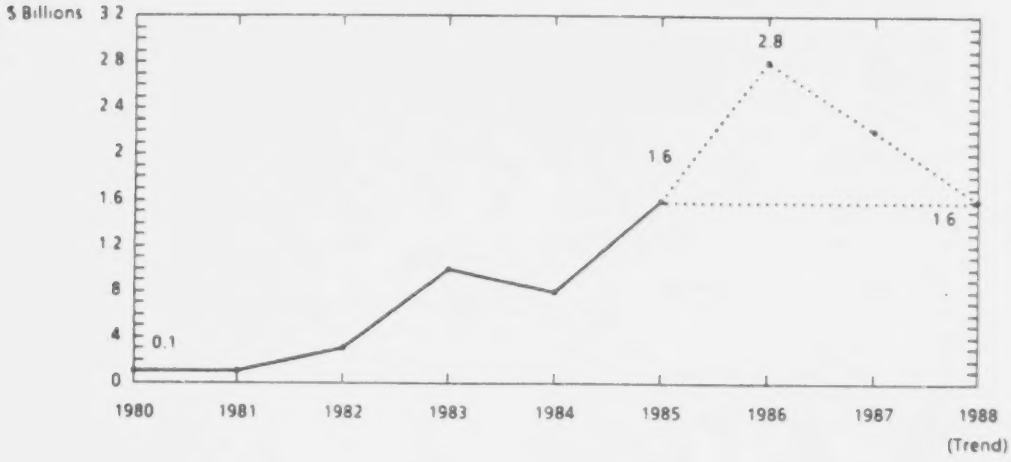
NYSE Average Daily Volume



Next, you want a more complete picture of mutual fund sales, as contained in **Exhibit 3**. Yes, we surely did hold at that phenomenal $1.6 billion during your absence. But that's down a dramatic 43% from the more phenomenal, and record $2.8 billion in 1986! Now the picture is starting to look quite different.

Exhibit 3

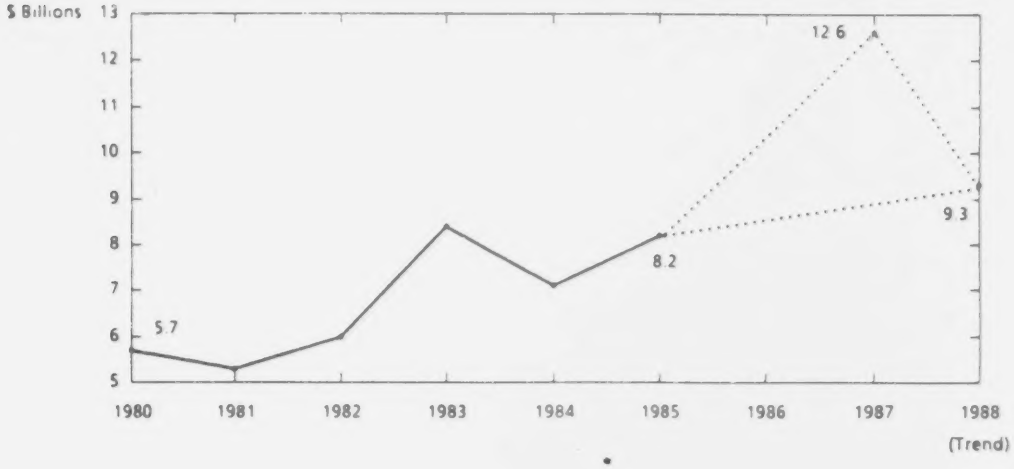
Securities Industry Revenues from Mutual Fund Sales



What about commission revenues? **Exhibit 4** shows that commissions did rise from $8.2 billion to $9.3 billion during your absence. But last year, commissions shot up to $12.6 billion. So, we're clearly up from 1985, but down 26% from 1987.

Exhibit 4

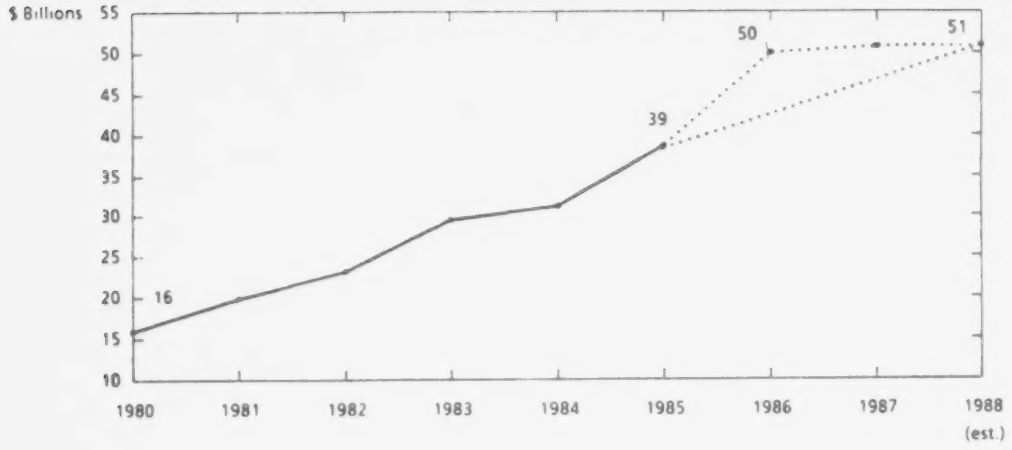
Commission Revenues



And how about total industry revenues, which are displayed in **Exhibit 5**? The $51 billion certainly looks good in relation to the $39 billion of 1985. But, total revenues have been essentially flat since 1986.

Exhibit 5

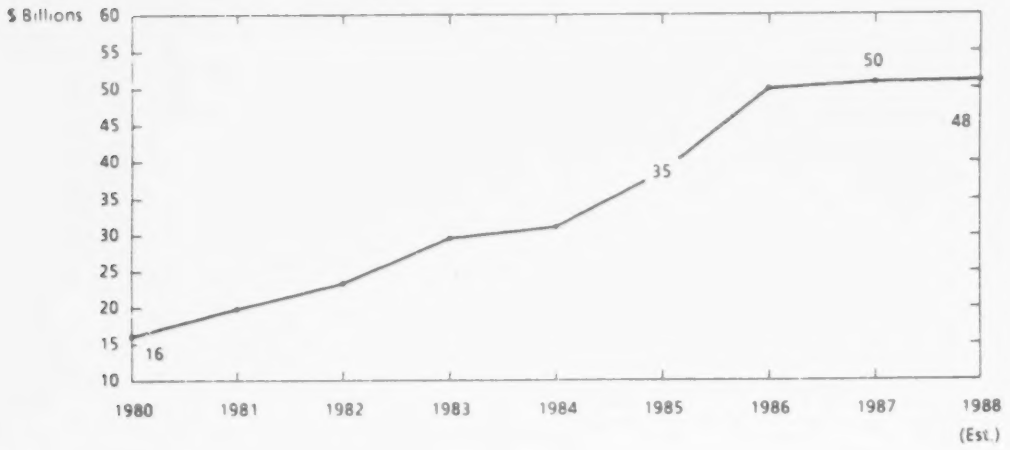
Securities Industry Revenues



With revenues flat for three years, you immediately hope that the expense side has been flat also. Not quite, according to **Exhibit 6**. Industry expenses moved up sharply in 1987, though happily, the year to date trend suggests total expenses in 1988 could be down a couple of billion dollars from 1987.

Exhibit 6

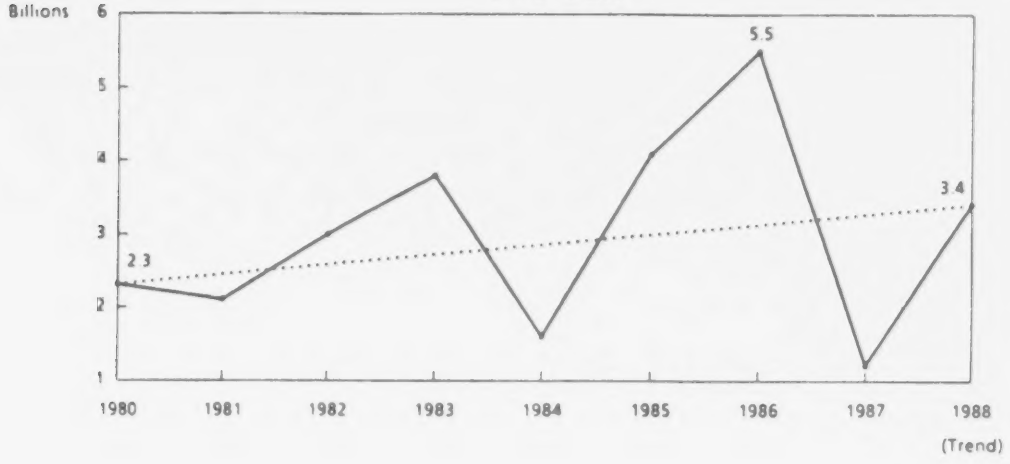
Securities Industry Expenses



At this point you're ready, but not eager, to see the bottom line. **Exhibit 7** shows that when you left in 1985, the industry earned a record $4.1 billion pre-tax that year. In 1986, it reached a new record $5.5 billion. But then, profits dove to $1.2 billion for 1987, including a $2.1 billion loss in the fourth quarter. If the second half of this year mirrors the first half, it appears pre-tax net will come in around $3.4 billion.

Exhibit 7

Securities Industry Net Income Pre-Tax



In **Exhibit 7**, the line drawn from the $2.3 billion of profits in 1980 to the $3.4 billion point of 1988 is the trend line of profitability. If the business actually grew in such an orderly fashion, this would be a far different business than it is and has been. The industry's bottom line has been more volatile than the markets themselves.

Although the bottom line of firms has been less than satisfactory, shouldn't brokers still be doing well? After all, a lot of business is being done.

Exhibit 8 shows that the average retail RR earned $80,000 in W-2 compensation for 1985. RR earnings should correlate with various barometers. For example, take mutual fund sales. You'll recall they were at $1.6 billion for 1985, and the trend line suggests fund sales will be about $1.6 billion again this year. So, based solely on the fund sales barometer, one would expect that the average earnings of retail brokers would hold steady at about $80,000.

But, based on total commissions, which have grown since 1985, one would expect broker earnings of about $90,000. Moving up the line, the growth in total revenues would suggest $105,000. The higher level of the Dow would suggest $109,000. And, the increase in NYSE trading volume would suggest $125,000.

Very pleasant and rosy expectations. What actually happened?

Exhibit 8 also shows the real story. If the second half of this year mirrors the first, average retail RR earnings will be down to about $63,000 -- much below the expectation one would get from looking at the various barometers.

Exhibit 8

Average Retail RR
Earnings -- Expectation vs Actual

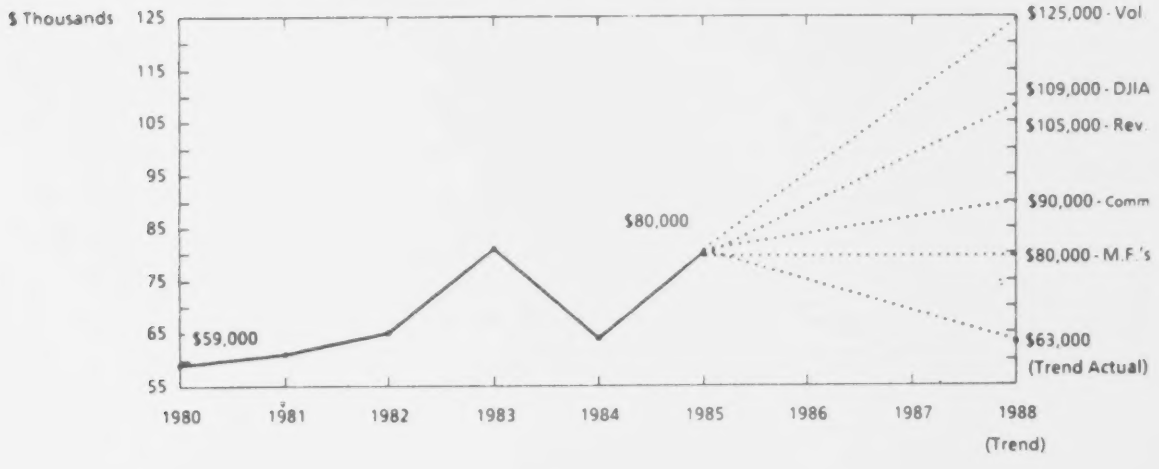
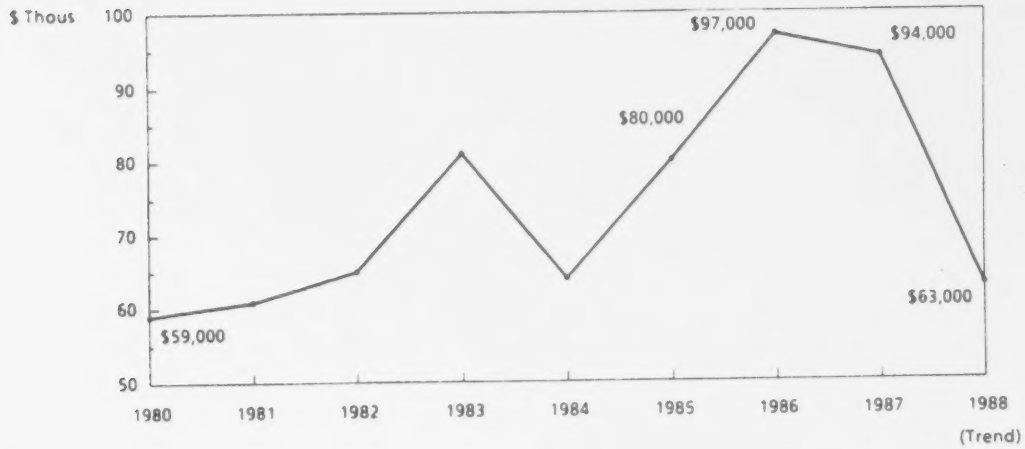


Exhibit 9 shows the year to year plottings in average retail RR earnings. They peaked at $97,000 for 1986; were an excellent $94,000 for 1987; and are now dropping back to what looks like about $63,000 for this year. Note the $63,000 isn't much different from the $59,000 of 1980. So, if you compare actual 1987 broker earnings with the trend for 1988, it's down 33%. Quite a drop.

Exhibit 9

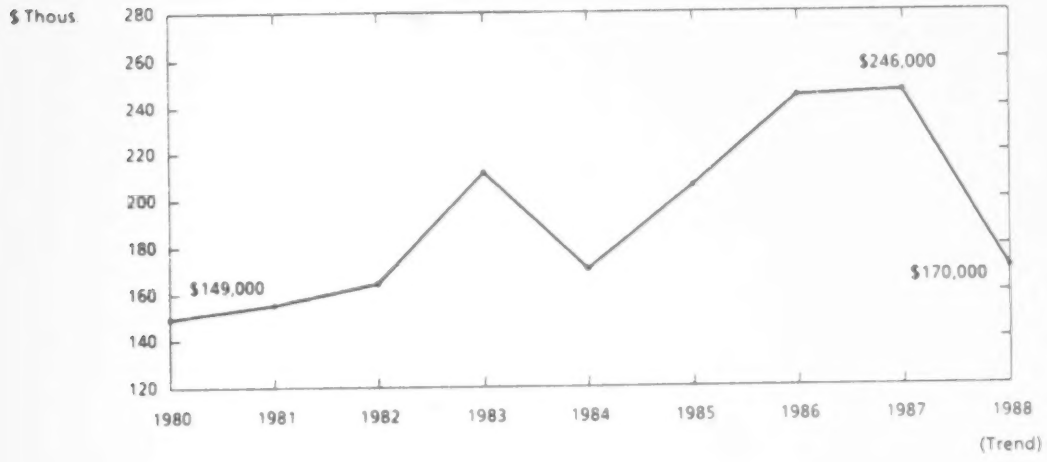
Average Retail RR
Earnings -- Expectation



That suggests that average production followed the same path -- and it did, as shown in **Exhibit 10**. This figure went from $246,000 last year down to an estimated $170,000, representing a 31% reduction in average production.

Exhibit 10

Average Retail RR Production



You're baffled. With all the barometers looking good, how could there be a sharp drop in retail RR earnings and production? It just doesn't make sense.

Well, as all of us who lived through the sea change that began last October know with excruciating clarity, there are fundamentally two reasons. First, concerned about uncertainty, investors have hunkered down, gone to the sidelines, reduced their activity. So, compared with last year, fewer tickets are being written. Second, concerned about risks, investors have gravitated to more conservative investments. So, again compared with last year, the products that are being sold tend to carry lower commissions and thus the sales credit per transaction is down. Fewer tickets with lower credits will yield lower RR production and earnings every time. We could go into more detail, but in essence, that explains the seeming anomaly. It's a different business.

You pause, ponder and then ask how the people running the firms view the situation. SIA recently surveyed the CEOs of 67 mid-size firms, asking them to identify their principal concerns. Here are the top three short-term concerns, almost entirely relating to profitability:

1. Adequacy of net profits.
2. Adequacy of gross revenues.
3. Profit margins.

Looking out three to five years, the top three longer-term concerns were entirely profitability:

1. Achieving solid profitability.
2. Profit margins.
3. Being able to at least break even during poor market periods.

What Now?

Dropping the hypothetical situation, what sort of story have we seen? Is it depressing? Is it pessimistic?

Maybe not! As Mark Twain once commented on Wagner's music, "It's not as bad as it sounds." The following reasons may show why the picture is not all that bleak.

1. We are doing a lot of retail business today. As we just saw, today's numbers when compared with those of just a few years ago are pretty darn good; for example, commissions, mutual fund revenues, the Dow, trading volume, even average production. The problem relates to our short-term orientation. We tend to compare things to the very recent past, and in this instance the recent past was an unprecedented, record-breaking time. But we shouldn't lose sight of the fact that we are still doing a lot of retail business today. Lots of brokers and offices are doing extremely well by any standard.

2. Among the numbers we looked at that were down substantially were average production and earnings. But again, the big drop is only in relation to the recent holiday we had. When one takes a longer view -- which is an important view to take in an industry characterized by cyclicality and volatility -- a different picture emerges. Consider RR earnings. During the 1980s, the average retail RR has done very well. If you take the first three years of this decade, RR earnings averaged $62,000--not at all bad. Then, if you take the most recent three years, the average is $85,000. Even better. Every year can't be a record, but the numbers are not only impressive, but getting better. And, we're talking "average" here. The better brokers, by definition, do still better.

3. Investor preferences have clearly changed. But investors still have financial needs; if anything those needs are greater than ever. And there's no one better able to meet those needs and address those preferences than the people in this business. We have the products, expertise, and accounts. We can do a terrific job for clients, one that reflects their concerns, uncertainties, aversions, and goals. Some of us may need to alter approaches or heighten efforts, but investors do need help and the business is there to be done.

4. If we do that terrific job for clients during this period, we should be in a superb position when the investment climate again brightens, which it inevitably will. (On that score, a recent SIA study revealed 91% of a large cross-section of sales and marketing executives in our business believe that at some point within the next three years, equities will once again become highly attractive.)
5. At the firm level, most are still generating considerable, though not record-breaking, gross revenues. If you have decent gross, there is the opportunity to manage in ways that will produce net. A good deal of progress is being made as firms go about adapting to the new climate.

The Problems We Face

So, with some longer term perspective, today's numbers aren't so terrible and the situation isn't all that bleak. Nevertheless, there are some serious challenges.

As we talk to one another about problems and challenges, what do we hear? Well, we hear about trade and budget deficits being too high. Election year uncertainties. Inflation jitters. The dollar. The markets being still vulnerable. We hear concerns about institutional domination. The flight to safety. Our newer brokers don't know how to deal with the present environment. And there's program trading in its varied forms. We also hear about customers on the sidelines. Frozen brokers. Costs being too high. Fierce competition. The fear that corporate profits are peaking. Investment taxation too high. Managers no longer sales leaders. Markets and prices jumping around too much. And, the securities business is getting bad publicity.

We've left out forest fires, hurricanes and the drought, but the list goes on and on. Clearly, there is no shortage of problems or tough challenges.

But, in trying to sort out the boatload of challenges faced by the retail side of the business, there are three that are especially key. Let's focus on them...briefly and without belaboring them.

Three Key Retail Challenges

The first key challenge is: Do our customers really understand how their investments have performed over the last two, three or five years?

There are many, many customers who have enjoyed fine and even excellent performance on their investments over the longer term. Yet, of the many who have benefited from fine performance, how many feel or think otherwise? Far too many do in fact think otherwise. By and large, the numbers for most investors are good when viewed over a period of years, but we as an industry have not done nearly enough, first, to put those performance numbers together...and, second, to help our customers understand those numbers in a reasonable context. Remedial action on this point is not only a key challenge, but a great opportunity.

A second key challenge also relates to customers and it is this: Have we done enough to develop "investment programs" for our customers; programs that are long-term, well conceived and systematic?

Perhaps a little vignette will illustrate this point. In the days immediately following October 19, 1987, all of us talked with investors who were shocked, disappointed, scared, upset or worse. However, one person with whom I talked was none of those things. He had taken a hit like the rest of us, but it didn't bother him much. He said:

- First, I've been following an investment plan on a consistent basis for a number of years.

- Second, over that period I've done quite well, even with the market break taken into account. I am actually ahead of what my plan calls for.

- Third, my investments are diversified -- munis, equities, corporates, real estate, money markets, etc.

- Fourth, I put in and reinvest new funds each month, so in effect I dollar cost average.

- Fifth, my investment goals are long term, and so I take a long term view of my investments. I don't get too excited by short term swings -- up or down.

That's not heavy duty financial planning, but it is an investment program that is long-term, well-conceived and systematic. More of our customers should be convinced to establish sound programs tailored to their individual needs. Accomplishing that end is a key challenge...and a big need.

The last key challenge is this: Do we have business plans that enable us to operate at least satisfactorily over all phases of the cycle? For many firms, clearly the answer is no. In the first quarter of 1988, 32% of NYSE firms doing business with the public lost money. In the second quarter, 42% lost money. This is an incredibly difficult challenge, but it can be met. We are aware of a handful of firms that during the good years developed plans designed to keep them profitable even if revenues were to drop by 20%, 30% or as much as 40% -plans which have since been implemented, and successfully. But by and large, as an industry we still face a big challenge in operating satisfactorily when the cycle moves off record-breaking highs and swings to levels that would have been sensational just a few years ago. And that is particularly true on the retail side. It's a key challenge, the importance of which is being borne out in the P&Ls around the industry.

Perhaps these numbers and observations help provide some added perspective. After you returned from your sabbatical and saw some of the current data you marveled, "Isn't this a great business!" You bet it is!

Adrian L. Banky
Executive Vice President and General Manager
Securities Industry Association

VOLUME

	JUL 1988	YTD 1988	JUL 1987	YTD 1987	% CHAN YTD 1988-1987
AVERAGE DAILY SHARE VOLUME ON					
NYSE (MILS.)*	145.7	167.3	177.3	181.1	-7.6%
AMEX (MILS.)*	8.4	10.1	12.4	13.7	-26.2%
NASDAQ (MILS.)*	111.8	125.1	148.3	149.9	-16.6%
REGIONAL EXCHANGE (MILS.)*	0.0	0.0	25.6	27.5	-100.0%
DOLLAR VALUE OF SHARES TRADED ON					
NYSE (MILS.)	$101,435	$1,044,556	$163,895	$1,426,618	-26.8%
AMEX (MILS.)	2,463	25,321	4,222	40,585	-37.6%
ODD-LOT SHARES PURCHASED ON NYSE (THOUS.)	6,759	64,282	9,481	96,452	-33.4%
ODD-LOT SHARES SOLD (INCLUDING SHORT SALES) ON NYSE (THOUS.)	14,805	133,580	15,465	157,856	-15.4%
NYSE BLOCK VOLUME AS A PERCENT OF TOTAL SHARES TRADED	54.7%	53.0%	49.8%	51.3%	----
CONTRACTS TRADED (THOUS.)					
CBOE OPTIONS	8,841	81,063	17,784	146,633	-44.7%
AMEX OPTIONS	3,354	28,059	4,733	41,165	-31.8%
COMMODITY	20,185	184,477	22,407	171,520	7.6%

*MONTHLY AVERAGE
N/A - DATA NOT AVAILABLE

YIELDS

(MONTHLY AVERAGES)

	JUL 1988	JUL 1987	BASIS POINT CHG 1988-1987
BOND BUYER INDEX (20 BOND)	7.76%	7.72%	4
CORPORATE BOND YIELDS (MOODY'S)			
Aaa CORPORATE	9.96	9.42	54
Baa CORPORATE	11.11	10.61	50
RATIO Aaa CORPS. TO Baa CORPS.	0.90	0.89	1

PRICES

(END OF MONTH)

	SEPT 1988	SEPT 1987	% CHAN SEPT 1988-1987
DOW JONES INDUSTRIALS	2112.91	2596.28	-18.62%
STANDARD & POOR'S 500	271.91	321.83	-15.51%
NYSE COMPOSITE	153.57	180.24	-14.80%
AMEX MARKET VALUE INDEX	301.63	356.45	-15.38%
VALUE LINE COMPOSITE	234.71	279.41	-16.00%
NASDAQ COMPOSITE	387.71	444.29	-12.73%

UNDERWRITING

	THIRD QUARTER 1988	THIRD QUARTER 1987	% Change 1988-1987
CORPORATE FINANCING (Gross New Issues - $ Mils)			
TOTAL	$206,267.0	$229,203.3	-10.0%
Common Stock	$23,757.8	$35,913.6	-33.8%
# of Common Stock Issues	312	776	-59.8%
Preferred Stock	$5,245.9	$10,138.5	-48.3%
# of Preferred Stock Issues	93	143	-35.0%
Corporate Debt	$177,263.3	$183,151.2	-3.2%
# of Corporate Debt Issues	2,296	1,992	15.3%
MUNICIPAL FINANCING (Gross New Issues - $ Mils)			
Negotiated	$61,959.3	$58,050.6	6.7%
# of Issues	2,621	2,543	3.1%
Competitive	$19,846.7	$18,250.0	8.7%
# of Issues	2,569	2,669	-3.7%

Source: IDD Information Services

RECENT INTERESTING READING AND STATISTICAL MATERIAL

Item	Description	Source
Prices Charged Retail Clients	New survey, to be released in November, details the prices individual investors pay for certain investment services. It is based on data from 77 SIA member firms, including large national wirehouses, regional firms, and smaller local firms. Commissions on agency stock and option transactions, fees for such items as postage and handling, IRA and pension accounts, legal transfers, and central asset management accounts are presented. Commission discounting, including the amounts of discounts and the extent to which discounts are given, is also discussed.	Bill Jordan SIA
Mutual Fund Investment -- After the October 1987 Market Break	Two-part study reviewing activity levels in mutual funds and reporting results of survey on mutual fund investor actions and attitudes. Sample highlights include: 1. Sales volume of stock, bond and income funds in 1988 is much more subdued than a year ago, but continues to be twice the level experienced in 1984. 2. The majority of fund owners, regardless of fund type, have taken little action since October 1987 to either redeem or exchange their funds.	ICI 1600 M Street, N.W. Washington, D.C. 20036
"Studies on Equities Markets"	Issue contains a collection of six articles examining certain technical issues related to equity market performance. The first three articles discuss the international character of the crash, including the worldwide transmission of the disruption from one national stock market to another. The last three articles examine the role of equity related margin requirements in the U.S.: 1. the diverse margin rules in various markets are summarized; 2. analytical and conceptual issues on "consistent" margins across markets is discussed; and 3. new evidence is introduced on how margin requirements may affect stock market activity.	Quarterly Review Federal Reserve Bank of New York 33 Liberty Street New York, N.Y. 10045
"The danger of revenue neutral"	Article criticizing the use of a static revenue forecasting model by the Jt. Tax Committee. Because of the considerable dynamic impact of lower capital gains taxes in stimulating economic growth, use of a static revenue model is particularly inappropriate. When it comes to taxation policy, Congress' "static model" has not thought for tomorrow.	Institutional Investor October 1988

Item	Description	Source
"The Bear Facts"	Although most firms have not cut payouts in response to a tough market, brokers are working harder than ever and taking home less. Nevertheless, the major firms are a little closer together in what they pay than they have been in the past, but there is disagreement over which way compensation will go in the months ahead.	Registered Representati October 1988
"Done Deal? -- FSLIC'S Bailouts May Come Apart"	Since mid-May, the embattled FSLIC has signed contracts providing an estimated $25 billion in subsidies to encourage takeovers of insolvent thrifts. But in the haste to do bailouts, FSLIC and its parent may be making deals that are destined to come apart. A key factor in the ultimate fate of these subsidized transactions is the uncertainty over the value -- or lack thereof -- of various assets of the troubled thrifts.	Barron's 10/24/88
"Tax Policy"	Special report detailing tax policy positions of Bush and Dukakis. Despite the disavowal of any interest in raising taxes, both presidential candidates favor significant tax policy changes. Examines proposals, estimates where available, and past records.	Bureau of National Affairs 10/28/88
"Derivative" Mortgage Securities and Their Risk/Return Characteristics"	The majority of residential mortgage loans originated in 1988 will be transformed into mortgage-backed securities, a large part of which will subsequently be turned into derivative mortgage instruments such as strips, REMICS and CMOs. In these products, cash flows from mortgage-backed securities are rearranged to suit the risk and maturity preferences of investors. This article analyzes the risks and rewards embodied in these new instruments under changing market and economic conditions.	FDIC Banking Review Fall 1988
"The Return of Second-Hand Rose"	Is Sandy Weill pushing his luck taking on Primerica? The stock market has reacted skeptically, but this article which reviews Primerica's troubles and Weill's career ends up putting its money with Weill.	Fortune 10/24/88